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No free shop: Why target companies sometimes choose not to buy 'go-shop' options[☆]

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ABSTRACT

We study the decisions by targets in private equity and MBO transactions whether to actively "shop" executed merger agreements prior to shareholder approval. Targets can negotiate for a 'go-shop' clause, which permits the solicitation of offers from other would-be acquirors during the "go-shop" window and may lower the termination fee paid by the target in the event of a competing bid. The decision to retain the option to shop is predicted by various firm attributes, including larger size and more fragmented ownership. Go-shops are not a free option. We exploit the impact of various characteristics of the firm's legal advisory team and procedures on the probability of inclusion of a go-shop provision to establish a negative relationship between go-shop provisions and initial acquisition premia. Importantly, that loss to shareholder value is not offset by gains associated with new competing offers. We conclude that the increased-use of go-shops reflects excessive concerns about litigation risks, possibly resulting from lawyers' conflicts of interest in advising targets.

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1. Introduction

The manner in which firms sell themselves in the market is an important, and little-studied, topic. Firms must decide whether to enter into an agreement with an acquiror as part of a bilateral discussion or as part of a broader "auction" process. Once they have chosen to do one or the other, they must decide how aggressively to continue to market themselves to other would-be acquirors prior to their shareholders' vote on the acquisition. Firms, unlike commodities, are unique assets and are acquired as part of a costly process of investigation by potential acquirors. Interestingly, the process is not uniform; the decisions targets make about how to market themselves to acquirors, both before and after they enter into an acquisition agreement, vary greatly.

A go-shop provision in a merger agreement enables the investment bank financial advisor to the target company to actively solicit (i.e., "shop") and negotiate with other potential acquirors after the initial agreement is signed with a reduced termination fee for a specified period of time (referred to as the "go-shop window"). Should the target board of directors determine to terminate the merger agreement with the acquiror based on a bid received during the go-shop window, the termination fee paid to the acquiror typically is much less than the full termination fee that would be payable after the go-shop window. In the absence of a go-shop provision in the merger agreement (i.e., in a "non-go-shop" setting), the target firm may still accept a competing bid during a pre-specified period, although it may not solicit one; termination fees in non-go-shops are typically higher than during go-shop windows.

Initially sparsely employed in merger agreements, over the last decade, "go-shop" provisions have become more common. Fig. 1 shows the number of deals in our sample per year for the period 2004-2011, as well as the proportion of go-shops. M&A activity peaked in 2006 and 2007, with 65 and 64 acquisitions announced in each of those years, respectively, declined sharply in 2008–2009 to 23 and 18 deals, respectively, and partially recovered in 2010–2011. During this period, go-shop provisions in our sample rose in popularity, and went from being employed in 13% of all deals in 2004 to 41% by 2007. Their share remained at similarly elevated levels through and after the crisis, and declined to 24% only in 2011. These patterns extend to the dollar volume of deals where, however, the decline in activity during 2008-2009 is more pronounced (Fig. 2).

In recent years, two academic commentators have argued that the option to shop an offer can, and on average does, lead to a higher price for the target firm.[1] The views of practitioners on the efficacy of go-shops have been mixed, however, with some suggesting that the go-shop may in certain circumstances be "window dressing" and others suggesting that the go-shop presents an opportunity to overcome a "much lower threshold of obstacles" than would be faced by a competing bidder in the absence of a go-shop.[2] It is also recognized that the option to shop for an offer may have an additional benefit of the reduction in litigation risk for the target.[3]

Nevertheless, when a target firm buys a go-shop option it must pay for that option, and in theory that payment should take the form of a lower initial offer price for the firm, ceteris paribus. The current literature on go-shops neither has come to grips fully with the tradeoffs between the costs and benefits of go-shops, nor has provided empirical evidence about go-shops that fully takes account of all those costs and benefits.

In this paper we examine the determinants of the target board's decision to include a go-shop provision in the initial merger agreement and, importantly, the effect of this contractual feature on bidding activity and pricing.

We find that a range of firm characteristics correlates with the decision to include a go-shop decision. Acquisitions where broad marketing (an "auction") was conducted as part of determining the initial bid are less likely to include a go-shop provision. And so are those involving target firms with high concentration with a blockholder. On the other hand, larger firms are more likely to include a go-shop provision.

The decision to include a go-shop provision is endogenously determined, and simple OLS estimates of its effect on deal outcomes may suffer from endogeneity bias. Our empirical strategy builds on previous work by Subramanian (2008) and Jeon and Lee (2014) to deliver plausibly unbiased estimates of the effect of go-shops on the initial offer bid and firm value.

Relying on simple difference in means tests, Subramanian (2008) finds pure go-shops – go-shop deals without pre-signing market checks – to result in a 5 percentage point increase in cumulative abnormal returns (CARS). Subramanian (2008) attempts to address the endogeneity bias by estimating the effect on a matched sample of go-shop and non-go-shop deals; the resulting estimates are not statistically significant. We argue that the matching method employed in Subramanian

[1] Subramanian (2008) and Jeon and Lee (2014).

[2] Compare Anderson and Corroon (2008) (observing that the utility of the go-shop is a function of the context in which the target board determines to negotiate for it and suggests that if the initial transaction is the product of overreaching by target management then the go-shop will have little utility) with Signal Hill Capital Group LLC (2012) (hereinafter "Signal Hill Study (2012)")(quoting Robert Friedman, former Chief Legal Officer of the Blackstone Group stating that "Go-Shops are meaningful···Both the strategic universe and the private equity universe would be reticent to come in during a classic non-go-shop process [after a signed deal is announced]. We just wouldn't do it. But when you put a 'For Sale' on the door, and say come get me then people drop everything and look because they are being invited in."). New York Times (2006), Sautter (2008), and Bloch (2010) specifically note the possibility that go-shops may be designed to provide litigation protection to targets, especially in the context of a "sweetheart" deal between the target and its management. For further references, see Jeon and Lee (2014).

[3] Compare Signal Hill Study 5 (observing that in the years 2010 and 2011 transactions with go-shops were subject to litigation 70% and 76% of the time, respectively) with Cornerstone Research (2013) (observing that M&A shareholder litigation of all deals valued at over $500 million impacted 95% and 96% of the deals in the years 2010 and 2011, respectively).

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